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U.C.C. Article 2A: Distinguishing Between True Leases and Secured Sales

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U.C.C. ARTICLE 2A: DISTINGUISHING BETWEEN TRUE LEASES AND SECURED SALES

Leases of personal property have been employed with increasing frequency in modern commercial transactions.¹ Courts have advanced several diverse interpretations regarding the proper treatment of such leases.² Currently, guided by common law precepts, disputes involving the leasing of chattels are often resolved by applying legal principles set forth in article 2 (sales) and article 9 (secured transactions) of the Uniform Commercial Code (the "Code").³ Since neither article 2 nor article 9 was specifically intended to regulate lease transactions, the prevalence of conflict in current law is not surprising.⁴ To remedy the disagreement which

¹ See Hazard, *Foreword* to U.C.C. art. 2A (1987). While leases of consumer goods such as automobiles have become somewhat more common, growth in the area of equipment leasing has been tremendous. See Mooney, *Personal Property Leasing: A Challenge*, 36 BUS. LAW. 1605, 1606 (1981). The term "equipment lease" generally indicates a long-term agreement which is often used as a substitute for the purchase of costly business equipment. *Id.* The increased utilization of this type of transaction has been largely influenced by federal income tax considerations. See U.S. DEP'T OF COMMERCE, INT'L TRADE ADMIN., A COMPETITIVE ASSESSMENT OF THE U.S. EQUIPMENT LEASING INDUSTRY 6-8 (1985) [hereinafter COMPETITIVE ASSESSMENT].

The domestic market for equipment leasing grew from about \$26.5 billion in 1978 to an estimated \$61.2 billion in 1983, an average annual growth rate of 18.2%. *Id.* at 3-4. As a percentage of capital equipment investment, leasing increased approximately 12% during that period. *Id.* at 3. In 1983, leases of equipment represented the largest source of funds for capital investment. *Id.* at 3, 5.

² See *infra* notes 19-34 and accompanying text.

³ See Hazard, *Foreword* to U.C.C. art. 2A (1987); Mooney, *supra* note 1, at 1608 & n.14.

⁴ See Hazard, *Foreword* to U.C.C. art. 2A (1987). "The legal rules and concepts derived from these sources imperfectly fit a [lease] transaction A statute directly addressing the personal property lease is therefore appropriate." *Id.* Article 2 is a modernized version of the Uniform Sales Act. U.C.C. § 2-101 official comment (1987). Although courts and commentators have advanced various interpretations of its scope, article 2 was primarily intended to govern the law of sales. See *id.* § 2-101 (short title of article is "Sales"); *id.* § 2-102 official comment (although security interests are specifically excluded from article's scope, sales aspects of such transactions are included); see also *O J & C Co. v. General Hosp. Leasing, Inc.*, 578 S.W.2d 877, 878 (Tex. Ct. App. 1979) (article 2 is expressly limited to sales).

Article 9 applies primarily to transactions creating security interests in personal property. U.C.C. § 9-102(1)(a) (1987). Whether article 9 governs a given lease transaction, therefore, depends upon whether a security interest as defined in U.C.C. § 1-201(37) (1987), has been created. *Id.* § 9-102 official comment.

has resulted, the American Law Institute ("ALI") and the National Conference of Commissioners on Uniform State Laws ("NCCUSL") have approved an amendment to the Code, including an entirely new article—article 2A—governing leases of personal property.⁵ In addition, several amendments necessary to bring existing Code provisions into conformity with the new article have been adopted.⁶ The most significant of the conforming amendments is the substantial revision of section 1-201(37).⁷ This definitional provision has been expanded considerably in an effort to clarify the distinction between those lease agreements which create "security interests" and those which do not.⁸

Among the reasons for the promulgation of article 2A was the desire to resolve certain basic issues,⁹ such as the appropriate legal definition of a lease.¹⁰ The new article contains detailed provisions

⁵ Hazard, *Foreward* to U.C.C. art. 2A (1987). Before it was included as an amendment to the Code, article 2A was proposed as the Uniform Personal Property Leasing Act. U.C.C. § 2A-101 official comment (1987). NCCUSL approved and recommended the substance of the new article in August 1986; ALI did the same in May 1987. *Id.* NCCUSL approved the final text of article 2A in August 1987. *Id.* The new article has been introduced in the state legislatures of California, Colorado, Connecticut, Delaware, Illinois, Massachusetts, Minnesota, New Hampshire, Oklahoma, Rhode Island, Utah, and Washington. Huddleson, *Old Wine in New Bottles: U.C.C. Article 2A—Leases*, 39 ALA. L. REV. 615, 618 & n.5 (1988). To date, however, article 2A has been enacted only in Oklahoma. *Id.*; see OKLA. STAT. ANN. tit. 12A, §§ 2A-101—2A-531 (West Supp. 1989).

⁶ See U.C.C. §§ 1-105(2), 1-201(37), 9-113 (1987). The amendment to section 1-105(2) adds two provisions of article 2A to its list of provisions superseding contrary agreement by the parties. See *id.* § 1-105(2). Section 9-113, which eliminated the need for filing a security agreement and provided for the secured party's rights to be governed by article 2 when a security interest arose solely under a sale, has been extended to include security interests arising under article 2A. See *id.* conforming amendment to § 9-113. For a discussion of the amendment to section 1-201(37), see *infra* notes 35-44 and accompanying text.

⁷ See U.C.C. § 1-201(37) (1987). While the amendments to sections 1-105(2) and 9-113 simply supply language which broadens the scope of those sections to apply to certain provisions of article 2A, the revision of section 1-201(37) contains significant changes to the definition of a security interest. See *id.* & official comment.

⁸ See *id.* & official comment. The past definition of security interest identified one situation where a lease created a security interest and another in which a security interest did not necessarily arise. See U.C.C. § 1-201(37) (1978). The amended subsection describes four situations in which a lease agreement automatically constitutes a security interest. See U.C.C. § 1-201(37) (1987). The amended provision further provides that a transaction does not create a security interest simply because it contains certain specified characteristics. See *id.* In addition, the amendment lists definitions and rules of construction. See *id.* For a discussion of specific aspects of the amendment, see *infra* notes 37-40 and accompanying text.

⁹ See U.C.C. § 2A-101 official comment (1987).

¹⁰ See *id.* The common law did not provide an adequate method for determining whether a given transaction is a true lease. See *id.* § 1-201(37) official comment. Further, the definition of security interest set forth in the past version of section 1-201(37) gave little

assigning specific meanings to numerous terms pertaining to lease transactions.¹¹ Another important point addressed by article 2A is the existence and effect of express and implied warranties with respect to leased goods.¹² In addition, part 5 of the new article speaks to the rights and obligations of the parties upon default, delineating remedies for both the lessee and the lessor.¹³

This Note will discuss the importance of clearly defining the term "lease." Following a review of judicial interpretations of the term, the new definitional provisions will be analyzed, with emphasis on the distinction between transactions creating true leases and those creating security interests. Finally, this Note will consider the significance of the term "nominal consideration," which has played an important role in judicial efforts to make this distinction.

I. THE MEANING OF "LEASE"

A. *The Importance of a Clear Definition*

Article 2A "applies to any transaction, regardless of form, that creates a lease."¹⁴ It is therefore necessary to make a preliminary determination concerning the nature of a particular transaction before treating it in accordance with the dictates of the new article.¹⁵ The scope of article 2A is broadly stated because it is intended to reach a wide range of lease transactions, from the sim-

help in making such a determination, and had been described as "vague and outmoded." *Id.* The changes to this provision seek to "draw a sharper line" between true leases and security interests. *Id.* Some commentators have suggested that the drafters failed to identify a bright line to guide courts in making determinations in this area. See McLaughlin & Cohen, 'Karl's Kode' Revised, N.Y.L.J., Jan. 26, 1988, at 2, col. 1.

¹¹ See U.C.C. § 2A-103 (1987). Section 2A-103 definitional coverage includes: consumer lease, finance lease, installment lease contract, lease, lease agreement, lease contract, leasehold interest, lessee, lessee in the ordinary course of business, lessor, lessor's residual interest, merchant lessee, and sublease. *Id.*; see also *infra* notes 35-42 and accompanying text (discussing meaning of lease under new article).

¹² See U.C.C. § 2A-101 official comment (1987). The law of warranty for leased goods has long been uncertain. See Farnsworth, *Implied Warranties of Quality in Non-Sales Cases*, 57 COLUM. L. REV. 653, 653 (1957).

¹³ See U.C.C. §§ 2A-501—2A-531 & 2A-101 official comment (1987). The majority of the provisions in this part are analogous to the remedy provisions for sales contracts, which are set forth in parts six and seven of article 2. Cf. *id.* §§ 2-601—2-725.

¹⁴ *Id.* § 2A-102.

¹⁵ See *id.* If the transaction is a lease of goods, it will be governed by the new article. See *id.* If, however, it is found to be a sale or secured transaction, articles 2 and 9 will control. See *supra* note 4.

plest rental agreements to the most complex business ventures.¹⁶ However, application is limited to leases of goods, and does not extend to sales or security interests.¹⁷ Distinguishing between these different forms of doing business, therefore, will have a significant impact on the rights and remedies of the various parties involved.¹⁸

B. Judicial Interpretation of the Term "Lease"

Courts have traditionally encountered difficulty in properly classifying transactions which parties have labeled leases.¹⁹ A recurring problem involves drawing a distinction between a true lease, and a transaction which actually creates a security interest but is disguised as a lease.²⁰ The past definition of security interest

¹⁶ U.C.C. § 2A-102 official comment (1987). In addition, if the parties to such a transaction have agreed that article 2A will govern, their intentions should be enforced by the court. *Id.* For a discussion of what constitutes a lease, see *infra* notes 36-40 and accompanying text.

¹⁷ U.C.C. § 2A-102 official comment (1987). "Goods" are defined as "all things that are movable at the time of identification to the lease contract, or are fixtures." *Id.* § 2A-103(h). Another potential restriction on the applicability of the article to lease transactions is contrary agreement by the parties. *See id.* § 2A-102 official comment. Consistent with the spirit of the Code, freedom of contract has been preserved, allowing the parties to determine the effect of their agreement. *See id.* By analogy, however, courts are permitted to apply principles of article 2A to leases of personal property other than goods. *See id.*

¹⁸ *See* Cohen, McLaughlin & Zaretsky, "Lease" or "Security Interest"? *Impending Clarification*, 1 COM. L. REP. 198, 199 (1987). Where the transaction is a true lease, "[o]n common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy." U.C.C. § 1-201(37) official comment (1987) (quoting 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 3.6, at 76 (1965)). Further, the distinction between these types of transactions has significance in connection with "state usury laws; third party rights; [and] Code filing requirements." Huddleson, *UCC Article 2A: Leases*, in A.L.I.-A.B.A. COURSE OF STUDY MATERIALS 205, 206 (1987).

¹⁹ *See* U.C.C. § 1-201(37) official comment (1987); *see also* Cohen, McLaughlin & Zaretsky, *supra* note 18, at 199-200 (considerable confusion exists in determining meaning of "lease"). Commentators have noted the existing confusion, recognizing the desirability of uniform treatment in this area. *See* Coogan, *Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?*, 56 N.Y.U. L. REV. 1036, 1057-58 (1981).

²⁰ *See* Mooney, *supra* note 1, at 1610 & n.23. Due to the inherent difficulties presented by attempting to distinguish these transactions, some commentators have suggested that little consequence should be attached to the distinction. *See* Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ. ST. L.J. 341, 354-55. *But see* Boss, *Leases and Sales: Ne'er or Where Shall the Twain Meet?*, 1983 ARIZ. ST. L.J. 357, 360 (criticizing Professor Ayer's notion that lease-sale distinction is meaningless). The distinction is significant because the body of commercial law that controls a given situation is dependent on the nature of the transaction. *See* Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 U. ILL. L.F. 446, 446. Courts have recognized that a purported lease agreement which is used to disguise another type of transaction should be subject to the same

found in section 1-201(37) offered little guidance for courts addressing this issue, and no judicial standard for making such a classification has emerged.²¹ It is well settled that this determination must be made on a case by case basis as the particular facts require.²² Courts have identified, however, an array of factors to consider in characterizing these transactions,²³ focusing primarily on the parties' intentions.²⁴

One of the primary considerations in determining the nature of a transaction is the possibility that the lessee will eventually own the leased goods.²⁵ An agreement is most appropriately classi-

analysis it would have undergone if the transaction's true nature had been disclosed. *See, e.g.,* Mid-Continent Refrigerator Co. v. Way, 263 S.C. 101, 108, 208 S.E.2d 31, 34 (1974) (article 2 applies to sale disguised as lease).

²¹ U.C.C. § 1-201(37) official comment (1987). The last two sentences of the 1978 version of section 1-201(37), which stated that the mere inclusion of a purchase option does not make a lease one intended for security but the fact that the lessee shall become owner or has an option to become the owner for no or nominal consideration does make it one intended for security, further added to the confusion surrounding the lease-security interest issue. *Id.*; see also Cohen, McLaughlin & Zaretsky, *supra* note 18, at 199 (statutory definition under 1978 Code is "of limited usefulness").

The courts' failure to enunciate a standard has resulted in substantial discordance with respect to this issue. *See* Coogan, *Leasing and the Uniform Commercial Code*, in EQUIPMENT LEASING—LEVERAGED LEASING 681, 692 (2d ed. 1980); Mooney, *supra* note 1, at 1613.

²² *See* U.C.C. § 1-201(37) (1987). "Whether a transaction creates a lease or security interest is determined by the facts of each case" *Id.*; see also Crest Inv. Trust, Inc. v. Atlantic Mobile Corp., 252 Md. 286, 289, 250 A.2d 246, 248 (1969) (facts are controlling to show parties' intent) (quoting *In re Alpha Creamery Co.*, 4 U.C.C. Rep. Serv. (Callaghan) 794, 797 (W.D. Mich. 1967)); IFG Leasing Co. v. Schultz, 217 Mont. 434, 436, 705 P.2d 576, 577 (1985) (facts of case determine character of transaction). Due to the inadequate standards for evaluating the facts, classification has been difficult. *See* Coogan, *supra* note 21, at 692.

²³ *See* Lease Fin., Inc. v. Burger, 40 Colo. App. 107, 111, 575 P.2d 857, 859-60 (1977); Crest Inv. Trust, 252 Md. at 289, 250 A.2d at 248 (quoting *In re Alpha Creamery Co.*, 4 U.C.C. Rep. Serv. (Callaghan) 794, 797-98 (W.D. Mich. 1967)); All-States Leasing Co. v. Ochs, 42 Or. App. 319, 327, 600 P.2d 899, 904 (1979); see also *infra* notes 25-34 and accompanying text (discussing various factors considered).

²⁴ *See* Lease Fin., 40 Colo. App. at 111, 575 P.2d at 859; Citizens & S. Equip. Leasing v. Atlanta Fed. Sav. & Loan Ass'n, 144 Ga. App. 800, 805, 243 S.E.2d 243, 247 (1978); Transcontinental Refrigeration Co. v. Figgins, 179 Mont. 12, 18, 585 P.2d 1301, 1305 (1978). Some courts focus on the purpose of the agreement to discern the parties' intent, rather than the language employed by the parties. *See, e.g.,* Rushton v. Shea, 419 F. Supp. 1349, 1365 (D. Del. 1976); Redfern Meats, Inc. v. Hertz Corp., 134 Ga. App. 381, 391, 215 S.E.2d 10, 17 (1975). But see *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 826 (N.D. Ga. 1966) (language of lease indicative of intent), *aff'd sub. nom.* Sanders v. National Acceptance Co. of Am., 383 F.2d 606 (5th Cir. 1967) (per curiam); Hawkland, *supra* note 20, at 448 (courts likely to enforce parties' declaration that transaction creates security interest).

Under section 1-201(37), objective factors, rather than subjective intent, control. *See* U.C.C. § 1-201(37) official comment (1987); *infra* note 42 and accompanying text.

²⁵ *See* All-States Leasing, 42 Or. App. at 327, 600 P.2d at 904; Hawkland, *supra* note

fied as a sale where its terms require the lessee to become owner of the goods.²⁶ Alternatively, a mere option to acquire the leased goods upon expiration of the lease term does not transform the lease agreement into a contract of sale.²⁷ If, however, the lessee has the opportunity to become the owner of the leased goods for nominal or no additional consideration, then the transaction will likely be deemed a sale.²⁸ Attempts to formulate a workable standard for

20, at 448-49. If title is to pass to the lessee, the transaction is likely to constitute a sale. See *Transcontinental Refrigeration*, 179 Mont. at 17, 585 P.2d at 1304 (sale is a "passing of title from the seller to the buyer" (quoting U.C.C. § 2-106(1) (1978))). Further, some courts consider the existence of a lessee's equity interest in the property as significant in drawing the lease-sale-security interest distinction. See *In re Tillery*, 571 F.2d 1361, 1365 (5th Cir. 1978); *In re Royer's Bakery, Inc.*, 1 U.C.C. Rep. Serv. (Callaghan) 342, 345-46 (E.D. Pa. 1963); *Hill v. Bentco Leasing, Inc.*, 288 Ark. 623, 625, 708 S.W.2d 608, 609 (1986).

²⁶ See *G.R. Pierce v. Leasing Int'l, Inc.*, 142 Ga. App. 371, 372, 235 S.E.2d 752, 754 (1977); *Redfern Meats*, 134 Ga. App. at 391, 215 S.E.2d at 17-18. If the lessee is obligated to return the goods to the lessor at termination of the lease period, and the goods are still valuable, then the lessor has a meaningful residual interest and the transaction is more likely to be recognized as a true lease. See *In re Samoset Assocs.*, 24 U.C.C. Rep. Serv. (Callaghan) 510, 516 (D. Me. 1978).

Some lease agreements require the lessee to pay a sum that approximates the value of the goods, regardless of whether the lessee will ever acquire an ownership interest in the property. Some courts have held that such "full-payout" leases automatically create security interests. See, e.g., *Leasing Serv. Corp. v. American Nat'l Bank & Trust Co.*, 19 U.C.C. Rep. Serv. (Callaghan) 252, 259 (D.N.J. 1976) (rental payments far in excess of value of leased property); *Citizens & S. Equip. Leasing*, 144 Ga. App. at 807, 243 S.E.2d at 248 (accelerated rentals approximate purchase price); see also *Hawkland*, *supra* note 20, at 448-49 (full-payout lease probably deemed security absent lessor's retention of residual interest); cf. *Rush-ton*, 419 F. Supp. at 1365 (obligation to pay value of goods is generally prerequisite of sale but does not "compel such a finding"). However, these decisions have been subject to criticism. See *Burke, Secured Transactions*, 34 Bus. Law. 1547, 1549-50 (1979); *Burke, Secured Transactions*, 32 Bus. Law. 1133, 1136-37 (1977).

²⁷ See U.C.C. § 1-201(37) (1987); *In re Tillery*, 571 F.2d at 1366; *In re Alpha Creamery Co.*, 4 U.C.C. Rep. Serv. (Callaghan) 794, 799 (W.D. Mich. 1967); *Crest Inv. Trust, Inc. v. Atlantic Mobile Corp.*, 252 Md. 286, 289, 250 A.2d 246, 248 (1969); *All-States Leasing*, 42 Or. App. at 327, 600 P.2d at 904.

Some courts have held that a mere option to purchase goods cannot transform a lease into a security interest because the term "security interest" contemplates the performance of an obligation. See, e.g., *RCA Corp. v. State Tax Comm'n*, 513 S.W.2d 313 (Mo. 1974); see also *Brokers Leasing Corp. v. Standard Pipeline Coating Co.*, 602 S.W.2d 278, 280-81 (Tex. Ct. App. 1980) (option, rather than obligation, to purchase does not create sale).

²⁸ See *Citicorp Leasing, Inc. v. Allied Inst. Distrib., Inc.*, 454 F. Supp. 511, 515-16 (W.D. Okla. 1977); *Peco, Inc. v. Hartbauer Tool & Die Co.*, 262 Or. 573, 575-76, 500 P.2d 708, 710 (1972); *FMA Fin. Corp. v. Pro-Printers*, 590 P.2d 803, 805 (Utah 1979); *Lectro Management, Inc. v. Freeman, Everett & Co.*, 135 Vt. 213, 216-17, 373 A.2d 544, 546 (1977).

Furthermore, where exercise of the option is the "only sensible course," the transaction is likely to be treated as one intended to create a security interest. See, e.g., *Percival Constr. Co. v. Miller & Miller Auctioneers, Inc.*, 532 F.2d 166, 172 (10th Cir. 1976); *Crest Inv. Trust*, 252 Md. at 289, 250 A.2d at 248; *Peco*, 262 Or. at 576, 500 P.2d at 710; *FMA Fin. Corp.*, 590 P.2d at 806.

determining nominality of consideration have been largely unsuccessful.²⁹ The absence of a purchase option has been given some attention, but generally is not determinative of a transaction's nature.³⁰

Courts have enunciated a miscellany of factors which may aid in the categorization of these transactions.³¹ For example, it has been suggested that a conditional sale is intended where total rental payments exceed the value of the leased goods;³² where the term of lease is longer than the estimated useful life of the property;³³ or where the lease is being employed as a financing device.³⁴

C. Article 2A Effect on the Lease-Sale-Security Interest Distinction

One of the most compelling reasons behind the recommendation of article 2A was the need to "sharpen the line" between pure

²⁹ See Mooney, *supra* note 1, at 1611. Many methods for determining whether or not consideration is nominal have been advanced. *Id.*; see *infra* notes 56-67 and accompanying text.

³⁰ See, e.g., *In re Tillery*, 571 F.2d 1361, 1366 (5th Cir. 1978) (absence of option does not make transaction lease); *In re Samoset Assocs.*, 24 U.C.C. Rep. Serv. (Callaghan) at 514-15 (security interest may exist without option); *Hill v. Bentco Leasing, Inc.*, 288 Ark. 623, 626, 708 S.W.2d 608, 609 (1986) (absence of option not conclusive); *Barco Auto Leasing Corp. v. PSI Cosmetics, Inc.*, 125 Misc. 2d 68, 70, 478 N.Y.S.2d 505, 510 (N.Y.C. Civ. Ct. N.Y. County 1984) (same). But see *IFG Leasing Co. v. Schultz*, 217 Mont. 434, 436, 705 P.2d 576, 577 (1985) (court found true lease because lessee had no option to obtain title to property at no additional charge upon expiration of lease term).

³¹ See *J.L. Teel Co. v. Houston United Sales*, 491 So. 2d 851, 858 (Miss. 1985); *All-States Leasing Co. v. Ochs*, 42 Or. App. 319, 327, 600 P.2d 899, 904 (1979). These considerations include which party bears the risk of loss, which party is responsible for charges incident to possession or ownership, and the purpose for which the property was purchased by the lessor. See *Hill*, 288 Ark. at 625, 708 S.W.2d at 609; *J.L. Teel*, 491 So. 2d at 858; *All-States Leasing*, 42 Or. App. at 327, 600 P.2d at 904; *Brokers Leasing*, 602 S.W.2d at 281; Mooney, *supra* note 1, at 1612; *infra* notes 32-34 and accompanying text.

³² See *National Equip. Rental v. Priority Elecs. Corp.*, 435 F. Supp. 236, 239 (E.D.N.Y. 1977) (citing *Leasing Service Corp. v. American Nat'l Bank & Trust Co.*, 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976)); see also *supra* note 26 (discussing full-payout leases).

³³ See *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 826 (N.D. Ga. 1966), *aff'd sub. nom. Sanders v. National Acceptance Co. of Am.*, 383 F.2d 606 (5th Cir. 1967) (*per curiam*); *J.L. Teel*, 491 So. 2d at 858.

³⁴ See *All-States Leasing*, 42 Or. App. at 327, 600 P.2d at 904-05 (financing lessor status one factor to consider); *Equico Lessors, Inc. v. Tow*, 34 Wash. App. 333, 340, 661 P.2d 597, 601 (1983) (financing lease treated differently than normal operating lease). A financing lease is a transaction in which the lessor procures the goods for the express purpose of leasing them to the lessee. *Id.* The lessor's role is primarily to enable the lessee to obtain goods which he could not otherwise obtain. *Id.* The financing lessor usually has no expertise with respect to the goods, and normally has limited, if any, contact with them. See generally P. NEVITT & F. FABOZZI, *EQUIPMENT LEASING* 78-100 (2d ed. 1985).

leases and certain secured transactions.³⁵ To effectuate this objective, the new article includes an assortment of definitional provisions clarifying words and phrases commonly associated with leases.³⁶ For example, the fundamental term "lease" is defined as a "transfer of the right to possession and use of goods for a term in return for consideration."³⁷ Further, the definition expressly excludes sales and security interests from its ambit.³⁸ Section 1-201(37) elaborates on the meaning of "security interest" by identifying four situations which constitute security interests.³⁹ Additionally, the new definitional section provides that a transaction does not constitute a security interest merely because it has certain enumerated characteristics.⁴⁰ According to the new section, the

³⁵ See U.C.C. § 1-201(37) official comment (1987); *supra* note 10 and accompanying text; see also U.C.C. § 2A-103(j) official comment (1987) (comprehensive rationale for further refining lease-security interest dichotomy).

³⁶ See *supra* note 11 and accompanying text.

³⁷ U.C.C. § 2A-103(j) (1987). The term "lease" includes a sublease, unless such a construction is clearly inconsistent with the context of the transaction. *Id.* The modern definition has its origin in the common-law understanding of a lease. See *id.* § 2A-103(j) official comment.

³⁸ *Id.* § 2A-103(j).

³⁹ *Id.* § 1-201(37) official comment. According to the new definition, a transaction creates a security interest if the lessee must pay for the right to use and possess the goods as an obligation for the term of the lease which the lessee cannot terminate, and one of the following four situations exists:

- (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
- (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
- (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
- (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Id. § 1-201(37).

⁴⁰ See *id.* The new definition states that a security interest is not created merely because a transaction provides any of the following:

- (a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,
- (b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,
- (c) the lessee has an option to renew the lease or to become the owner of the goods,
- (d) the lessee has an option to renew the lease for a fixed rent that is equal to or

particular facts of each case still control the characterization of a given transaction.⁴¹ However, the new provision offers greater guidance to courts because it places emphasis on the economic realities of the deal rather than the parties' subjective intent.⁴² In addition, the amended provision contains guidelines for ascertaining a functional standard of nominality.⁴³ Although these guidelines are somewhat helpful, it is evident that a gap exists between option prices which are clearly nominal and those which are not.⁴⁴ Where the guidelines are not of assistance, the drafters suggest that the lease-security interest distinction be based on the facts and circumstances surrounding the transaction.⁴⁵ It is submitted that this reference to a determination on the facts of each case will cause judges and practitioners to resort to pre-article 2A standards of classification, which have proven inadequate. Furthermore, it is suggested that the guidelines advanced apply largely to cases

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- greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or
- (e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

Id.

⁴¹ *Id.*

⁴² See *id.* § 1-201(37) official comment. Attempts to ascertain parties' intent led courts to rely on factors that did not validly distinguish between sales and leases. *Id.* The recently amended section 1-201(37) shifts the focus away from subjective intent and towards economic analyses. See *id.*; see also Huddleson, *supra* note 18, at 207 (under § 1-201(37), objective factors control lease-sale distinction). Prior to the codification of article 2A, some courts had suggested that economic factors should control. See, e.g., *Rushton v. Shea*, 419 F. Supp. 1349, 1365 (D. Del. 1976) (economic consequences determine whether lessor retained ownership or security interest); *In re Samoset Assocs.*, 24 U.C.C. Rep. Serv. (Callaghan) 510, 512-13 (D. Me. 1978) (court must rely on economic circumstances rather than name parties give transaction in making lease-sale distinction).

⁴³ U.C.C. § 1-201(37) (1987). The section provides:

For purposes of this subsection (37):

- (x) Additional consideration is not nominal if (i) when the option to renew the lease is granted to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised.

Id.

⁴⁴ See *id.* § 1-201(37) official comment. The drafters acknowledged the existence of this gap where the consideration is less than fair market value, yet not so insignificant as to be deemed nominal. *Id.*

⁴⁵ *Id.*

where classification is not a difficult task. The more difficult cases will inevitably fall into the gap.

Recognizing the impossibility of addressing every conceivable fact pattern, the drafters left further development in this area to the courts.⁴⁶ It is submitted that while the new provision is beneficial to the extent that it promotes uniformity of treatment for the situations covered, judicial discordance will continue until the term "nominal consideration" is more precisely defined.

II. NOMINAL CONSIDERATION

Whether or not a transaction will be classified as a lease or a secured sale often depends on the meaning that is attached to the term "nominal consideration."⁴⁷ For example, an option to purchase goods at the end of a lease term is considered to create a security interest only if the purchase price is nominal.⁴⁸ Although amended section 1-201(37) provides guidelines for determining what constitutes nominal consideration, formulation of a more definite standard is needed.⁴⁹ The proffered guidelines state that an option price equal to the goods' fair market value at the time the option is exercised is not nominal.⁵⁰ The section further sets forth

⁴⁶ *Id.* The drafters felt that further elaboration on the definition of security interest would unnecessarily complicate the definition. *Id.*

⁴⁷ *See id.* § 1-201(37); *see also supra* note 28 and accompanying text (discussing lessee's option to buy for nominal or no additional consideration).

⁴⁸ U.C.C. § 1-201(37) (1987).

⁴⁹ *See supra* note 44 and accompanying text.

⁵⁰ U.C.C. § 1-201(37) (1987). Many courts have recognized the importance of the fair market value of the leased property in determining nominality. *See infra* note 61 and accompanying text. One federal court, however, has held that an option price may be nominal even if it is equivalent to the fair market value of the goods at the end of the lease term. *See National Equip. Rental, Ltd. v. Priority Elecs. Corp.*, 435 F. Supp. 236, 239 (E.D.N.Y. 1977). The court pointed out that goods which are almost worthless at the end of the lease term could be sold at a fair market value of, for example, one dollar, which in the court's view would be nominal. *Id.* Moreover, the court was uncomfortable with the practical consequence that parties could determine the nature of a transaction simply by setting an option price equal to the goods' value at the end of the term. *Id.*

Further, it is noteworthy that this guideline does not mandate that an option price be equal to the goods' fair market value in order not to be considered nominal. *See* U.C.C. § 1-201(37) (1987). Rather, it leaves room for option prices below fair market value to be classified as nominal or not according to the facts and circumstances of each case. *See id.*; *see also supra* text accompanying note 45 (distinction may be fact sensitive). Interestingly, according to guidelines promulgated by the Internal Revenue Service, for federal tax purposes a transaction will not be considered a true lease if the lessee is able to purchase the equipment at the end of the term for any price which is less than its fair market value. *See COMPETITIVE ASSESSMENT, supra* note 1, at 7.

the rule that additional consideration which is less than the lessee's reasonably predictable cost of performing under the lease if the option is not exercised constitutes nominal consideration.⁵¹ Since cases which do not fit neatly within these guidelines will likely be analyzed with reference to pre-2A standards of nominality, an examination of prior case law is essential.⁵²

Nominal consideration has been described as "any amount which is trivial compared with the value or the purchase price of the goods."⁵³ Case law has utilized a variety of tests in determining nominality, most of which are based on a comparison of the option price and some other ascertainable value connected with the transaction.⁵⁴ Once the appropriate value to which the consideration will be compared is selected, the inquiry usually focuses upon the relation which the option price bears to this value.⁵⁵

One of the comparisons frequently employed in determining nominality is that between the option price and the list price or original cost of acquisition of the property.⁵⁶ Some courts have applied the rule of thumb that an option price of less than twenty-five percent of the goods' list price constitutes nominal consideration.⁵⁷ Others have noted that an option price equal to ten percent of the lessor's cost is sufficiently insignificant to be considered nominal.⁵⁸ Another way courts have approached the issue of ade-

⁵¹ U.C.C. § 1-201(37) (1987); see *supra* note 43.

⁵² See *supra* text accompanying notes 45-46.

⁵³ 1 R. ANDERSON, UNIFORM COMMERCIAL CODE § 1-201:270, at 322 (3d ed. 1981).

⁵⁴ See Mooney, *supra* note 1, at 1611; see also *infra* notes 56-67 and accompanying text (discussing various approaches used by courts to determine if consideration is nominal).

⁵⁵ See Mooney, *supra* note 1, at 1611.

⁵⁶ See, e.g., *In re Samoset Assocs.*, 24 U.C.C. Rep. Serv. (Callaghan) 510, 513 (D. Me. 1978) (using purchase price or cost of acquisition as point of reference); *FMA Fin. Corp. v. Pro-Printers*, 590 P.2d 803, 805-06 (Utah 1979) (comparing, among other things, lessor's cost of property to option price).

As one alternative for determining nominality, the drafters of article 2A considered a comparison between the option price and some minimum absolute percentage of the original value of the goods. See Huddleson, *supra* note 5, at 628; see also *infra* note 68 and accompanying text (discussing other test contemplated by the drafters).

⁵⁷ See, e.g., *In re Alpha Creamery Co.*, 4 U.C.C. Rep. Serv. (Callaghan) 794, 797-98 (W.D. Mich. 1967) (thirty-two percent option price held not nominal); *Crest Inv. Trust, Inc. v. Atlantic Mobile Corp.*, 252 Md. 286, 288, 250 A.2d 246, 248-49 (1969) (fifty-five percent option price held not nominal); see also *Bonczek v. Pascoe Equip. Co.*, 304 Pa. Super. 11, 18, 450 A.2d 75, 80 (1982) (referring to twenty-five percent rule of thumb).

⁵⁸ See *Samoset*, 24 U.C.C. Rep. Serv. (Callaghan) at 513; *FMA Fin.*, 590 P.2d at 806. But see *Granite Equip. Leasing Corp. v. Acme Pump Co.*, 165 Conn. 364, 368, 335 A.2d 294, 295 (1973) (where trial court found true lease, appellate court refused to hold that consideration equal to ten percent of original purchase price was nominal as matter of law to convert

quacy of consideration is to compare the option price to the aggregate rental payments over the lease term.⁵⁹ Option prices ranging from less than one percent up to ten percent of total rentals have been held nominal.⁶⁰

A method frequently utilized in classifying consideration as nominal or not has been to assess the option price in terms of the goods' fair market value at the time the option is exercised.⁶¹ Some courts have looked at the actual value of the property at the time of exercise in making this comparison.⁶² Others, however, have recognized that the fair market value reasonably anticipated by the parties at the time they entered into the transaction should be considered.⁶³ Predictably, no "bright-line percentage" has emerged

transaction into one intended for security).

⁵⁹ See *In re Oak Mfg.*, 6 U.C.C. Rep. Serv. (Callaghan) 1273, 1276 (S.D.N.Y. 1969); *James Talcott, Inc. v. Franklin Nat'l Bank*, 292 Minn. 277, 283, 194 N.W.2d 775, 780 (1972).

⁶⁰ See, e.g., *In re Washington Processing Co.*, 3 U.C.C. Rep. Serv. (Callaghan) 475, 478-79 (S.D. Cal. 1966) (option price of ten percent of total rentals created security interest rather than true lease); *James Talcott*, 292 Minn. at 283, 194 N.W.2d at 780 (option price of \$2 held nominal as compared to approximately \$73,000 total rentals).

In many cases, courts have noted that where the lessee has no sensible alternative to exercising an option to purchase the leased goods, it is likely that a security interest was intended by the parties. See, e.g., *Percival Constr. Co. v. Miller & Miller Auctioneers, Inc.*, 532 F.2d 166, 172 (10th Cir. 1976) (exercising option was only "sensible course of action"); *Bonczek*, 304 Pa. Super. at 18, 450 A.2d at 80 (same); *Tackett v. Mid-Continent Refrigerator Co.*, 579 S.W.2d 545, 548 (Tex. Ct. App. 1979) (no sensible alternative existed); *FMA Fin.*, 590 P.2d at 806 (comparison of option price to sensible alternatives).

⁶¹ See *Peco, Inc. v. Hartbauer Tool & Die Co.*, 262 Or. 573, 576, 500 P.2d 708, 710 (1972) (court considers this standard best one to use in determining nominality of option price); *Tackett*, 579 S.W.2d at 548 (same); *FMA Fin. Corp. v. Pro-Printers*, 590 P.2d 803, 806 (Utah 1979) (fair market value is most relevant inquiry).

⁶² See *Peco*, 262 Or. at 576, 500 P.2d at 710; *Tackett*, 579 S.W.2d at 548; *FMA Fin.*, 590 P.2d at 805-06.

⁶³ See, e.g., *In re Marhoefer Packing Co.*, 674 F.2d 1139, 1144-45 (7th Cir. 1982) (in addition to actual fair market value of property at end of term, court may look to value parties anticipated at time lease was signed); *Whitworth v. Krueger*, 98 Idaho 65, 68, 558 P.2d 1026, 1029 (1976) (\$10 option price for cattle which parties anticipated would be worth over \$10,000 held nominal).

One author has suggested that:

The key consideration in determining whether a lease transaction is a true lease or a disguised secured transaction is whether the price at which the option to purchase may be exercised is a reasonable approximation of the expected value of the goods at the time the option is to be exercised or whether it is nominal in comparison with the expected value of the goods at that time.

E. REILEY, *GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY* § 1.4(h), at 1-24 (1981). The drafters of article 2A also considered a standard of nominality that turned on the anticipated value of the leased goods. See *Huddleson*, *supra* note 5, at 628; *infra* note 68 and accompanying text.

as a standard,⁶⁴ but an option price of ten percent of the value of the property has been held nominal⁶⁵ while a price approximating fifty percent of the goods' worth has been upheld as substantial.⁶⁶

Many courts have utilized the fair market value approach, in conjunction with one or more of the other methods mentioned, to produce a fair result.⁶⁷ In addition, this standard was the basis for one of the formulas contemplated by the drafters of article 2A to clarify the term "nominal consideration."⁶⁸ It is submitted that this comparison should constitute the primary factor in determining whether or not consideration given in exchange for goods is nominal. Since it is unlikely that a bright-line approach will ever be uniformly espoused, it is suggested that the other existing comparisons continue to be used when the option price, as a percentage of fair market value, is susceptible to more than one interpretation.

CONCLUSION

The dramatic growth in the personal property leasing industry which has taken place in recent years has stimulated a much needed reevaluation of the applicable law. In the absence of a comprehensive and identifiable body of law governing the subject, principles borrowed from other areas of law, such as real estate,

⁶⁴ See *Marhoefer*, 674 F.2d at 1144.

⁶⁵ See *Peco*, 262 Or. at 577, 500 P.2d at 710 (10% option price); see also *Percival Constr. Co. v. Miller & Miller Auctioneers, Inc.*, 532 F.2d 166, 171 (10th Cir. 1976) (10.6% option price).

⁶⁶ *Marhoefer*, 674 F.2d at 1144-45. In instances where no evidence of the goods' fair market value is presented, some courts have recognized that such information would have been helpful in determining if consideration is nominal. See, e.g., *Granite Equip. Leasing Corp. v. Acme Pump Co.*, 165 Conn. 364, 368, 335 A.2d 294, 295 (1973) (evidence of fair market value would assist court); *Tackett v. Mid-Continent Refrigerator Co.*, 579 S.W.2d 545, 548 (Tex. Ct. App. 1979) (evidence of goods' fair market value provides "best test").

⁶⁷ See, e.g., *In re Oak Mfg.*, 6 U.C.C. Rep. Serv. (Callaghan) 1273, 1278 (S.D.N.Y. 1969) (comparisons between option price and total rentals, list price, and fair market value); *Peco, Inc. v. Hartbauer Tool & Die Co.*, 262 Or. 573, 576, 500 P.2d 708, 710 (1972) (comparison of option price to fair market value and existence of sensible alternatives); *FMA Fin. Corp. v. Pro-Printers*, 590 P.2d 803, 805-06 (Utah 1979) (comparison of option price to cost of property, sensible alternatives, and fair market value; all tests relevant).

⁶⁸ See *Huddleson*, *supra* note 5, at 628. The drafters of article 2A considered two formulas which set forth specific artificial percentages to determine what constitutes nominal consideration. *Id.* One of contemplated methods was to compare the option price to some substantial fixed percentage of the "reasonably predictable fair market value" of the goods at the time the option was to be exercised, with the reasonable prediction to be determined at the time at which the transaction was entered. *Id.*

bailments, sales, and secured transactions, have been applied to leases in a disorderly manner producing inconsistent and unpredictable results. The drafters of article 2A sought to dispel this confusion by promulgating uniform rules which would be both appropriate to the nature of the lease transaction and easy to apply. Many provisions of the new article meet these criteria and should facilitate the resolution of disputes arising from lease transactions. This Note has suggested, however, that the sections attempting to distinguish between true leases and security interests may prove inadequate. While these provisions represent a marked improvement over their predecessors, it is submitted that more definite standards are needed, especially the determination of a more accurate definition of what constitutes nominal consideration.

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